

CALIFORNIA STATE TEACHERS' RETIREMENT BOARD  
INVESTMENT COMMITTEE

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SUBJECT: Corporate Governance-Discussion

ITEM NUMBER: 10

ATTACHMENT(S): 5

ACTION: \_\_\_\_\_

DATE OF MEETING: March 3, 1999

INFORMATION: X

PRESENTER(S): Ms. Okada  
Ms. Hester Amey

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**EXECUTIVE SUMMARY**

When an investor purchases a share of stock in a corporation, that investor becomes a part owner of the corporation. This status is also known as a shareholder or stockholder. Taken as a group, shareholders are the owners of the corporation. Unlike bond holders or creditors, who have a fixed and determined claim on the corporation's assets, shareholders assume all the risks of management's stewardship of the corporation. If management enhances the assets of the corporation, shareholders will benefit by increased appreciation and possibly, dividends. If management squanders or mismanages the assets of the corporation, shareholders will lose, by reduced market value, dividends, possibly even bankruptcy. As a result of the at-risk nature of shareholders' capital, shareholders have a continuing say about how the corporation is governed and the overall business concentration of the enterprise.

Shareholders are legally entitled to a say in the major policy decisions effecting the operation, structure and direction of the corporation. This say or responsibility is called corporate governance. In the United States, the process of incorporation is addressed in a variety of state laws. However, all these laws say that shareholders cannot be disenfranchised by management alone; shareholders must agree to have their ownership and/or voting power diluted. The Board of Directors of a corporation are fiduciaries, accountable to the shareholders (owners) and responsible for the oversight of the management of the corporation. The Board of Directors acts an agent for the shareholders and is there to insure that shareholder interest is fairly represented.

Corporate governance activity at the California State Teachers' Retirement System (CalSTRS) is a combination of the daily analysis and voting of the corporate actions, and the filing and support of shareholder resolutions, class actions and litigation, when deemed appropriate. During the last fiscal year, CalSTRS reviewed and executed proxies on over 2,800 companies; this represented analysis on over 7,500 proxy issues.

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The following attachments provide additional information on Corporate Governance at CalSTRS and in general.

- Attachment 1– definition, history and activity of corporate governance at CalSTRS, flow chart of CalSTRS’ corporate governance process, and a description of the Council of Institutional Investors.
- Attachment 2 – CalSTRS’ policy on corporate governance, “Statement of Investment Responsibility”.
- Attachment 3 – CalSTRS’ guidelines for voting proxies, “Financial Responsibility Criteria for Corporate Investments”.
- Attachment 4 – corporate governance chronology.
- Attachment 5 – Glossary of terms.

## CalSTRS CORPORATE GOVERNANCE

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### **BACKGROUND--General**

The corporation is the most successful institution of our time, both flexible and adaptable. The structure is that of a pyramid, with the shareholders at the top and the board of directors and management on either side. Shareholders actually have an ownership interest or equity in the corporation. This ownership is normally represented by a stock certificate; in the case of large institutional owners, the entries are electronic and evidenced by their custodians. If accountability lines were to be drawn, one of the arrows would point upwards from the boards of directors to shareholders, and the other would point upwards from management to the boards of directors. Put simply, the board of directors is the only group who owes a fiduciary obligation to the shareholders; it acts as an agent for the shareholders. The shareholder attains this ascendant position because of his/her investment of capital in the corporation. Each time a share of stock is purchased by CalSTRS, the fund becomes a part owner in the underlying business. This money does not have a guarantee, in the way that debt has and assumes the business risks of the enterprise. This assumption of risk means that the shareholder should have a continued say about how the corporation is governed and its business concentration. A variety of state laws cover the process of incorporation, but all say that a shareholder cannot be disenfranchised by management alone, that shareholders have to agree to have their ownership and/or voting power diluted.

The public corporation that CalSTRS invests in today is far different than the ones which existed in the United States one hundred years ago. The bulk of corporations were owned and controlled either by a single entrepreneur, such as John Rockefeller or Andrew Carnegie, or by a family trust, such as the DuPonts, or by a private bank, such as the House of Morgan. This structure ensured that there would be no meaningful distinction between the motives of owners and managers of capital. The types of corporations which are now represented in the CalSTRS portfolio, had their beginnings in the stock boom of the 1920s. Today's publicly owned corporation is one in which management is separated from ownership and ownership is fragmented among many shareowners. When the stock market crashed in the late 1920s, many large family-owned blocks were dispersed, and more and more corporations were left without any dominant owner. Berle and Means provided the first intellectual description and analysis of the modern corporation in a now classic text called, The Modern Corporation and Private Property. This study showed that management was able to make all real decisions, including how the corporation was governed, legally the province of the shareholders, due to the wide dispersion of ownership.

Stockholders are legally entitled to a say in the major policy decisions effecting the operation, structure, and direction of the corporation. This ability to have a voice in the affairs of a corporation is called corporate governance. The corporate governance rights

of shareholders are supported by stock exchange rules, particularly the New York Stock Exchange, state incorporation laws, the courts, and the Securities and Exchange Commission (SEC). This network of authorities has been both a bane and a blessing to shareholders. Many simple items are still unresolved; for example, many states regard a proxy as a piece of paper and do not accept votes, either by telephone or over the computer, as being legitimate executions of the vote. This means that shareholders will have to go state-by-state to get the law to catch up with the technology. Corporations have similar concerns with the filings required by the SEC: Although the agency allows filings to be done electronically by corporations, it does not regard electronic filings as fulfilling its disclosure requirements.

### **EMPLOYEE RETIREMENT INCOME SECURITY ACT (ERISA)**

Nearly every transaction involving an employee benefit plan is subject to the fiduciary responsibility and prohibited transaction provisions of the Employee Retirement Income Security Act of 1974, as amended and the Internal Revenue Code of 1986. This is the controlling document for all private pension plans in America. Essentially, this is the fiduciary standard designed to protect workers from finding themselves destitute upon retirement, due to the management of the employee benefit plans by the employer. In its original design, the act would have also covered state and local government employees, but effective lobbying resulted in the exemption of public sector plans. Nevertheless, despite the success of the lobbying, public sector plans are keenly aware of ERISA's example and do what is necessary to adhere to the same standards as those laid down for private sector employees. The ERISA standard was designed to resolve questions of conflict of interest and liability that had left many workers with uncertain futures upon retirement. Many states have crafted very similar standards to protect government workers from the conflict presented by the state executive having control over the funding of public sector pension plans. As with ERISA, these state provisions are modeled on Trust Law and invoke the prudent person rule. The ability to keep conflicts under control is suspect, under both the private pension laws and the public sector laws. This is because in both instances, the plans have a non-neutral fiduciary, essentially, employers and employees are both settlors and beneficiaries. This is often called ERISA's fundamental contradiction, the so-called "Exclusive Benefit Rule."

California has specific law governing the administration of the Teachers' Retirement Fund and it is known as the Teachers' Retirement Law (E. Richard Barnes Act). The fiduciary obligations contained in Sections 9 and 17 of the California Constitution are expressly referenced in this law. Among the items listed in the Teachers' Retirement Law is the requirement for an investment advisor who is experienced in corporate management issues (section 22354).

### **HISTORY AT CALSTRS**

CalSTRS formed a Subcommittee on Corporate Governance in January 1985. After a nationwide search, the first Corporate Affairs Advisor was hired in August 1985. At that time, there was a great deal of merger and takeover activity and many companies were making use of anti-takeover protections. CalSTRS focused its early efforts on reducing or

eliminating those management defenses. In the 1985/86 proxy season, CalSTRS introduced over 20 shareholder proposals on the defenses such as poison pills, classified boards, greenmail, and dual class capitalization stock issuance. In the initial stages, CalSTRS corporate governance activity concentrated on the defensive tactics without regard to the underlying performance of the stock.

Three years later, in 1988, CalSTRS decided that the performance criteria was paramount and that CalSTRS would introduce shareholder proposals only on companies that demonstrated long term under-performance, relative to the S&P 500 Index, and to peers or industry group segments. CalSTRS also made the decision that shareholder proposals would be introduced only on companies that were held in an indexed portfolio. This decision was made on a strategic basis caused by a buy and hold investment approach. It was reasoned that since the active managers could easily sell a stock that was disappointing, the indexed portfolio should be the focus of any corporate governance activity.

Although CalSTRS has at times been seen as an activist shareholder, the core of the Corporate Affairs activity is the day-to-day analysis and voting of the corporate actions received at the fund. This includes mergers, acquisitions, indenture changes on bond issues, securities class action filings, bankruptcy and reorganization proposals. Logistics do not permit the Teachers' Retirement Board (TRB) to participate in the daily work of this area, but staff is required to report the votes taken and to attest to the execution of the TRB's policies.

### **COUNCIL OF INSTITUTIONAL INVESTORS**

The Council of Institutional Investors (CII), a California Nonprofit Mutual Benefit Corporation was formed in January 1985. CalSTRS, CalPERS, along with the State of Connecticut and the New York City Pension Systems, were founding members of CII. CII was founded because of pension fund investors' frustration with anti-takeover tactics on the part of management, especially the payment of greenmail, exclusionary tenders and the establishment of poison pill plans. It was thought that large pension fund and institutional investors needed a common voice on corporate governance / investment issues in order to better achieve their long-term investment goals. CII is not a shareholder and does not vote on shareholder issues. The organization is member driven and studies corporate governance issues, proposed and existing legislation (Federal and State), regulatory actions and corporate actions which may effect the value of its members' investments.

There are currently 188 members of CII representing over \$1 trillion in pension fund assets and 15 million plan participants. CII was instrumental in the revisions to the shareholder proposal rules in 1992, the passage of the Securities Litigation Reform Act in 1995, the defeat of the proposed tax on pension fund investment transactions and many other institutional investor-friendly actions. CalSTRS' representatives serve on the CII Executive Committee and attend quarterly business meetings.

## **STATE TEACHERS' RETIREMENT SYSTEM STATEMENT OF INVESTMENT RESPONSIBILITY**

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### **I. Philosophy**

The Teachers' Retirement Board finds that:

It is the fiduciary responsibility of the Board of the State Teachers' Retirement System to discharge its responsibility in the interest of the participants and beneficiaries and for the primary purpose of providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering the System; the investment policy of the System should reflect and reinforce this purpose.

Public retirement systems operate in a unique and complex social-economic milieu, providing for substantial disclosure of their operations and investment activity and placing them in a position where they should be above that of the private sector in social responsibility activities.

The System's responsibility extends to its participants and beneficiaries and to the general public. In addition to its fiduciary responsibilities to its members, the Board has the social and ethical obligation to require that corporations in which securities are held meet a high standard of conduct in their operations.

The act of investment in the securities of a corporation predominantly reflects a judgment that the ownership will produce a rate of return which will make it an attractive investment. While not outwardly signifying approval of all of a company's policies and products, it is possible however that such investment may be interpreted as an indication of the shareholders approval or support of all of a company's policies and products.

The System is a large investor and as such, is in a position to exert influence on the corporations in which it has invested.

### **II. Principles**

Consistent with these findings, the System establishes the following principles to govern the development of a responsible investment policy:

#### **A. Preservation of Principal and Maximization of Income**

The preservation of principal and maximization of income will clearly be the primary and underlying criteria for the selection and retention of securities.

#### **B. Non-Economic Factors**

Non-economic factors will supplement profit factors in making investment decisions. Non-economic factors are defined as those considerations not directly related to the maximization of income and the preservation of principal. The consideration of non-economic factors is for the purpose of ensuring that the Retirement System, either through its action or inaction, does not promote, condone or facilitate social injury.

C. Social Injuries Defined

Social injury will be said to exist when the activities of a corporation serve to undermine basic human rights or dignities. Basic human rights and dignities include, but are not limited to:

1. Equal Employment

Equal employment opportunity, including: fair and equitable recruitment and hiring, equal wages and benefits for equal and comparable worth, fair and equitable promotional and training opportunities, and the right to organize and join representative trade unions and associations if a majority of the employees so elect.

2. Housing

Equal access to safe and decent housing.

3. Basic Services

Equal access to basic services including medical care, transportation, recreation and education.

D. Corporate Practices

Social injury may also be said to exist when the Board, having followed the procedure set forth in Section IV.C.2, perceives that it is the prevailing belief of the members of the Retirement System that the practices of a corporation result in undesirable side effects for others, and that the side effects are grave in nature. Side effects which may be deemed grave in nature shall include, but not be limited to:

1. Environmental

Practices which are known to endanger the environment, subject to current federal, state and local law, including:

- a) Unsafe nuclear waste disposal;
- b) Ineffective or inadequate pollution control; or
- c) Improper use of chemicals and contaminants; or
- d) Any practice which directly or indirectly endangers human health or the environment.

2. Suppression of Human Rights

Practices which result in the suppression of human rights including:

- a) The sale of weapons and technology to governments known to engage in the systematic suppression of human rights; and
- b) The sale or purchase of goods from countries known to employ forced labor.

3. Human Health

Practices which endanger human health including:

- a) Sale and distribution of known contaminated products;
- b) Sale and distribution of therapeutically ineffective or dangerous drugs; and
- c) Purchasing goods from or selling goods to companies known to disregard worker safety.
- d) A company should not be held responsible for the infliction of social injury merely by virtue of its agreements or relationships with other (independent) entities engaged in socially injurious activities.

E. STRS Involvement

The extent of the responsibility of the System to engage in activity for the prevention, reduction, and elimination of social injury should be determined by:

- The number of shares held in the corporation;
- The gravity of the social injury.

In support of the aforementioned principles, the System sets forth the following guidelines for social responsibility in investments.

III. Selecting New Investments

In selecting new investments for the System, the Board adopts the following guidelines for both domestic and international investments.

- A. Investments shall not be selected or rejected based solely on social responsibilities.
- B. Social factors shall be taken into consideration to that such factors bear on the financial advisability of the investment; e.q., not investing in a corporation whose conduct has had a demonstrated negative effect on the corporation's financial viability.
- C. Generally, social criteria, to the extent available, should be considered after all financial criteria have been satisfied.

IV. Exercise of Shareholder RightsA. Proxy Voting

- 1. The System has a duty to cast its votes on all proxy issues related to companies in which it holds securities or to abstain with written notification to the company involved on any proxies it returns. In cases of abstention, where an important social responsibility issue is raised, the System should provide an explanation of its action.



2. The System should vote its shares in favor of resolutions which, if implemented, would prevent, reduce, or eliminate social injury as defined above. The System should oppose resolutions which cause or facilitate social injury.
3. If a resolution places a company at a substantial disadvantage with respect to its direct competitors who are equally guilty of inflicting social injury, the System should ascertain whether the company in question has made reasonable effort to induce voluntary industry-wide compliance. If it is determined that this course of action has been pursued, the System should abstain. In the event that a corporation has not initiated such activity, the explanation accompanying abstention should include an exhortation for compliance.
4. The State Teachers' Retirement System, as a major corporate shareholder, will actively vote its proxies to elect corporate board members who share the interests and philosophy of the System.
5. The System should routinely monitor corporate practices for compliance with the Board's criteria, i.e., monitor corporate compliance with the Sullivan principles'.

B. Other Shareholder Rights

1. For the purpose of insuring that a company may be made aware of any policies, procedures, or products of which the Board does not approve, and for the purpose of prevention, reduction or elimination of social injury, the Board may initiate action to supplement the responsible voting of proxies including but not limited to: (a) correspondence with the company, (b) meet and confer sessions with management or other stockholders, (c) entering into agreements with management or other stockholders, such as making provisions for reporting and other monitoring activities, and (d) the initiation, when determined necessary, of shareholder proposals.

C. Procedure

1. Responsibility for the implementation of social responsibility guidelines is delegated to the Board's Investment Committee. Ultimate authority and responsibility rests with the Board.
2. To assist the Board in determining whether social injury exists, the Board should:
  - a. Upon request, permit the presentation of relevant testimony by members of the System and members of the general public during Board meetings;

- b. Establish contact with appropriate regulatory agencies, such as Equal Employment Opportunity Commission, Environmental Protection Agency, Occupational Safety and Health Agency, Nuclear Regulatory Commission, Securities Exchange Commission, and others which are covered by laws of the United States Government or the State of California;
- c. Contact qualified persons representing parties affected by the corporate practice in question.

V. **Sanctions**

- A. When the remedies provided in B (above) indicate that there is little or no possibility of obtaining from a company a commitment to pursue activities designed to correct practices or policies involving grave social injury, the Board should consider either making no new investments or divestment if consistent with sound investment practice. Factors contributing to such a determination include, but are not limited to:
  - 1. Repeated refusal by management and a majority of stockholders to support shareholder proposals which the Board feels are necessary to insure socially responsible behavior;
  - 2. Failure of management to comply with Board requests for the disclosure of economic or non-economic information important to making investment decisions, in particular, information pertaining to company practices and policies which might result in social injury.
- B. A company committing social injury should not be subject to consideration for divestment if it is determined that the company is engaged in socially beneficial activity, where the resulting benefits are held to be greater than the injury. However, it is not the intention of this paragraph to imply a condonation of the social injury, nor does it preclude the exercise of shareholder rights in an effort to reduce such injury.

ADOPTED BY THE TEACHERS' RETIREMENT BOARD JUNE 16,1978

REVISED BY THE TEACHERS' RETIREMENT BOARD SEPTEMBER 24,1982

REVISED BY THE TEACHERS' RETIREMENT BOARD APRIL 27, 1984

REVISED BY THE TEACHERS' RETIREMENT BOARD APRIL 21, 1989

REVISED BY THE TEACHERS' RETIREMENT BOARD JANUARY 9, 1990

REVISED BY THE INVESTMENT COMMITTEE NOVEMBER 5, 1997

ADOPTED BY THE TEACHERS' RETIREMENT BOARD NOVEMBER 6, 1997

## **FINANCIAL RESPONSIBILITY CRITERIA FOR CORPORATE INVESTMENTS**

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The following criteria deal with matters considered of a financial nature only. In most cases they are general policy guidelines to voting shares held at annual and special corporation shareholder meetings. They are not designed to substitute for analysis and judgement which should be exercised as circumstances dictate. The guidelines should not be regarded as mandatory, if local factors and prudence suggest otherwise. Each issue will be reviewed to ascertain surrounding facts, and exceptions may be made based on the legal requirements of the countries, local conventions or states in which the company is registered. It is recognized that, in foreign markets, there may be practical difficulties in obtaining notices of company meetings and that the timeliness and disclosure requirements, which prevail in the U.S., are often not evident. In those circumstances where adequate and timely disclosure of information necessary to reach an informed and meaningful decision is not possible, the responsible party may abstain. It is also recognized that the decision to abstain by the party responsible for voting the proxy may be due to practical difficulties, to other financial criteria which outweigh the benefits to be gained by voting or to practical difficulties and circumstances beyond its control. (1) Notwithstanding any limitations, it is expected that there will be no abstentions on issues that may affect the economic value of the shareholdings. It is expected that in all cases, the parties will make a good faith effort to get the necessary materials, but it is recognized that, in foreign markets, the means for obtaining planned company meeting notices, dates and agendas, may not be readily available. Nevertheless, a true and accurate record shall be kept of the materials, which have been obtained, and of how proxies have been voted or otherwise managed. This record shall include, to the extent possible, a description of efforts made to obtain materials, which were not successful and the reasons why the efforts were not successful. It is understood that it is the intent of the Teachers' Retirement Board to exercise its voting authority, either directly or through other parties, to whom it has delegated responsibility for voting proxies, according to their judgement of its best financial interests, whenever and wherever possible, and that, while logistics or other factors may sometimes interfere with this intent and principle, it is the ultimate goal of the System to work with the indicated parties to remove the barriers to voting all shares over time.

### **A. AUDITORS**

1. When there is reason to believe the company's auditors have become complacent in the performance of their auditing duties, a vote against that auditors' continuance may be cast.

### **B. BOARD OF DIRECTORS**

1. Generally, information and circumstances permitting, votes are to be cast in favor of annual election of all directors and against staggered terms. Exceptions may be made as circumstances dictate or when pertinent information is unavailable. Once all shareholders have decided through the voting process that the board should be staggered, nominees should be elected based on their qualifications and merits, though STRS' interest may argue for actions proposing the repeal of staggered terms.
2. Generally, votes are to be cast in favor of simple majority approval, of shares outstanding, as appropriate for merger proposals. Proposals seeking higher percentages may be approved only if approval is in the financial interest of STRS. Exceptions may be made when pertinent information is unavailable. For example, a proposal which sought to reduce the super majority requirement from 80% to 66 2/3% would generally receive a favorable vote; whereas, a proposal to increase the vote required from a simple majority to a higher percentage would generally not receive a favorable vote.

3. It is concluded that corporate board members primary responsibilities should be to direct the companies in the interest of all the shareholders. Any proposed director qualifications should relate to a prospective director's capacity to function on behalf of all the shareholders; to the extent that such qualifications are disclosed, votes are to be cast on this basis. However, as a matter of policy, STRS supports the concept of an independent non-executive chairman, who has not had a substantive employment relationship with the company in the past five years. Shareholder proposals which seek a non-executive chairman will generally receive support and may be introduced on behalf of STRS.

Sitting directors who have been on the board for a full year and who have not attended at least 75% of the meetings will receive a negative vote. In such cases, the System will split its votes on the issue of directors and vote against the individual nominee. In casting its vote regarding directors, the financial performance of the subject corporations will be reviewed, and if long-term underperformance, relative to the market and industry group are severe, a negative vote may be cast for the entire slate of directors.

4. Generally, votes are to be cast against blanket requests for limitations of liability and indemnification protection of directors and officers. Generally, such requests allow the protected individual to escape liability even if he or she is found by the courts to have been grossly negligent in the performance of his or her duties as a director and/or officer of the corporation. It is concluded that it is not in the best interest of shareholders to grant such protection on an-across-the-board basis. Exceptions may be made as circumstances and legal requirements dictate.
  - A. Legal requirements and circumstances permitting, positive votes may be cast for management sponsored proposals requesting increased indemnification of directors and officers due to damage caused by violations of the duty of care, so long as the director/officer satisfied a "good faith" standard. Broader protection may be supported, provided there is a reasonable basis for support.
  - B. Legal requirements and circumstances permitting, positive votes may be cast for increased indemnification proposals where a director/officer defense is unsuccessful, unless there is a final legal/court determination that the director/officer acted in bad faith and not for a purpose that he or she could reasonably believe was in the best interest of the company. Broader protection may be supported, provided there is a reasonable basis for such support.
  - C. Legal requirements and circumstances permitting, negative votes may be cast against company proposals that request the elimination or limitation of directors' liability for acts evolving from negligence, or other violations of the duty of care that go beyond reasonable standards, except in markets where local conventions suggest otherwise.
5. Votes may be withheld for the entire slate of directors if a majority of the candidates are also corporate officers. Votes may be cast against the entire slate of directors if a majority of the candidates are also corporate officers or have been corporate officers in the past of the company. Additionally, votes may be withheld when it appears that the existing board has been remiss in the performance of its oversight responsibilities. In the absence of adequate or definitive information, the System will cast its vote based on the surrounding circumstances and the judgement of the responsible party.

6. Votes are generally to be cast against the payment of fees to inside directors. Votes are generally to be cast against proposals granting retirement benefits and/or stock options, stock grants to outside directors, except in markets where local conventions suggest otherwise. However, proposals which seek to pay outside directors' fees in stock instead of cash will receive a positive vote. In the absence of adequate or definitive information, the System will cast its vote based on the surrounding circumstances and the judgement of the responsible party.
7. Votes may be withheld for directors who may have an inherent conflict by virtue of receiving consulting fees from a corporation such as legal counsel and investment bankers who underwrite the corporation's securities. It is concluded that outside directors should remain independent in order to serve the best interest of all shareholders. In the absence of adequate or definitive information, the System will cast its vote based on the surrounding circumstances and the judgement of the responsible party.
8. Generally, votes should be withheld for the entire slate of proposed directors when management is proposing a series of defensive measures, which serve to insulate incumbent management and hinder the ability of mergers or takeovers to proceed. In the absence of adequate or definitive information, the System will cast its vote based on the surrounding circumstances and the judgement of the responsible party.
9. Where director candidate(s) are employed by a company having a 20% or greater interest in the subject company, the director candidate(s) will be considered insiders. Should the majority of the director candidates be insiders or have conflicts of interest, votes may be withheld for the entire slate of candidates. In the absence of adequate or definitive information, the System will cast its vote based on the surrounding circumstances and the judgement of the responsible party.
10. Generally, shareholder proposals requesting the board of directors to establish a nominating committee for the selection of director candidates are to receive a favorable vote. The System believes that all important review committees such as nominating, audit and compensation should be entirely staffed by independent directors. Proposals and/or actions which seek to have such a structure established may be initiated or supported by STRS. In the absence of adequate or definitive information, the System will cast its vote based on the surrounding circumstances and the judgement of the responsible party.
11. Proposals which seek to limit the tenure of directors should receive a negative vote. Proposals which require directors to own a minimum amount of company stock in order to qualify as a director or to remain on the board should receive a negative vote. In the absence of adequate or definitive information, the System will cast its vote based on the surrounding circumstances and the judgement of the responsible party.

### **C. CORPORATE GOVERNANCE**

1. Whenever possible, votes will be cast in favor of cumulative voting proposals as required for governmental pension funds under California law. (Section 6900, Government Code)

2. Generally, information, legal requirements and investment analysis permitting, votes may be cast against proposals which would grant preemptive rights to shareholders and in favor of proposals which would eliminate such rights. In some markets, preemptive rights result in a loss of financing flexibility and are likely to deter companies from fulfilling one of their functions, which is to raise capital advantageously. However, in some markets it is believed that the removal of preemptive rights result in a loss of financing flexibility. Thus, the party responsible for executing the vote must exercise his or her best judgement on this matter.

#### **D. EXECUTIVE COMPENSATION**

1. Stock options and incentive compensation plans must have the overriding purpose of motivating corporate personnel. To insure that such plans are cost and performance effective, attention should be paid to corporate performance. Exceptions may be made when pertinent information is unavailable or when legal requirements do not permit execution of this principle.

“Generally, proposals which only seek to enable corporations to comply with the tax code deductibility rules regarding executive pay are to receive a favorable vote. Exceptions may be made in the instance of mega grants, unclear links between performance, performance hurdles that seem too generous given past history, and no defined peer group by which to judge performance of the subject corporation. Tandem stock options, stock appreciation rights, purchased options may receive a negative vote. Generally, tandem options are a combination of stock options and another type of long-term incentive such as restricted stock or phantom stock. This vehicle can allow for cashless exercise, depending upon the executive choice of exercise or payment. The System is opposed to cashless exercise. Purchased options are usually purchased for a percentage of the grant value and are payable at the time of grant. The exercise price is set below the fair market value of the underlying stock. Indexed options will be reviewed on a case-by-case basis.”

2. Votes are generally to be cast against executive incentive stock option plans which would result in greater than 10% of the outstanding shares of the Corporation being reserved exclusively for the executive stock option plan, except in markets where local conventions suggest otherwise. This figure includes shares proposed for a new plan or amendment plus shares reserved under all existing plans, plus all shares under option but not yet exercised. Typically, no greater than 1 percent dilution per year for the life of the plan should be experienced by shareholders. Exceptions may be made when pertinent information is unavailable or when legal requirements do not permit execution of this principle.
3. Votes are generally to be cast against executive incentive stock option plans which would sell shares to executives at a price of less than 85% of market value at the time of grant, unless a lower value may be legally offered.
4. Votes are generally to be cast against executive incentive stock option plans which would grant loans to such executives for the purpose of exercising stock options. Exceptions may be made when pertinent information is unavailable or when legal requirements do not permit execution of this principle.
5. Votes are generally to be cast against executive incentive stock option plans which would grant loans to such executives to settle tax liabilities associated with the exercising of incentive stock options. Exceptions may be made when pertinent information is unavailable or when legal requirements do not permit execution of this principle.

6. Votes are generally to be cast against Restricted Stock Option Plans, outright stock grants or other arrangements to such as pyramiding, stock appreciation rights and cashless exercise. Votes are generally to be cast against proposals which would allow the board to replace or reprice underwater options without shareholder approval. Exceptions may be made when pertinent information is unavailable or when legal requirements do not permit execution of this principle.
7. Executives are defined as the five most highly compensated executive officers of a Company and its subsidiaries, and such other senior-level executive and management employees who are designated to receive executive incentive compensation, apart from that which is given to general employees. Exceptions may be made when pertinent information is unavailable or when legal requirements do not permit execution of this principle.
8. It is the responsibility of the companies to clearly, understandably, and adequately explain the plans and their effects with examples where necessary in order to fully define intent. However, where time permits, inquiry may be made about corporate proposals which are not clear. If the information available and/or obtained is not considered clear or adequate, votes cast will be based on the surrounding circumstances and the judgement of the responsible parties.
9. Corporate proposals to reduce stock option share prices for management should be given close scrutiny. If it appears the request arises out of a broad market decline affecting all companies, favorable consideration is possible. If the stock has underperformed the market and it is concluded the causes were management decisions, a negative conclusion would be probable. Such proposals will be considered on a case-by-case basis.
10. Generally, any attempt to create an unusually favorable compensation structure in advance of sale of a company should be opposed; however, such proposals will be considered on a case-by-case basis.

#### **E. EMPLOYEE COMPENSATION**

1. Generally, employee stock purchase plans, savings and investment plans, or thrift plans are to receive a positive vote, so long as exercise or purchase price is not less than 85% of fair market value on the date of grant or purchase, and no loans are made for the purposes of settling payment for shares or any tax liability arising from exercise or purchase of such shares. Shares issued and reserved with respect to such plans shall only be done when necessary and for the specific uses of the plans. However, such proposals will be considered on a case-by-case basis.

Generally, ESOP 's which are funded by the debt of the corporation and/or which represent large percentages of the outstanding shares or cause substantial dilution to ownership and voting power are to be given a careful review. In the absence of any extraordinary or beneficial (to STRS) circumstance, these plans should not be approved. Shareholder proposals which seek to have a vote on all such plans should receive a positive vote.

**F. MERGERS, ACQUISITIONS, AND TAKEOVERS**

1. STRS wants all offers evaluated on its behalf, which are presented for any company in which it invests. To the extent that adequate information is available and legal requirements, and investment practices permit, defensive tactics should be opposed. Each proposal should be reviewed on its own merit, as nothing written here should be constructed as a substitute for the judgement of the responsible party. These defensive tactics may be, but are not limited to:
  - A. Golden parachutes.
  - B. Poison-pill preferred.
  - C. Lock-up options.
  - D. Super majority voting provisions, with the exceptions noted above in Section B (2).
  - E. Fair price or minimum price provisions.
  - F. Unequal voting rights based on length of ownership of stock.
  - G. Requiring that shareholders only be allowed to act at meetings rather than by written consent.
  - H. Requiring that all offers be approved by the company's management and/or Board of Directors before offers are submitted to shareholders.
  - I. Requiring that only the Board be allowed to increase its size, or that a super majority of all outstanding shares is necessary to create a larger Board, and allowing the Board to fill vacancies on the Board in between meetings, without shareholder approval.
  - J. Requiring that directors may only be removed for cause, usually on the basis of a supermajority vote, and that directors be allowed to fill vacancies for full terms rather than the remainder of unexpired terms.
  - K. Providing for a set of designated "alternate" directors to be appointed to any mid-term vacancy.
  - L. Requiring that the power to call a special meeting of the shareholders be vested in the board and/or the Chairman exclusively, or providing that such a meeting can only be called after a demand by a supermajority of stockholders, or increasing the number of shareholders necessary to constitute a quorum at an annual or special meeting.
  - M. Adopting supermajority voting provisions for transactions between the target company and an "interested shareholder."
  - N. Requiring that the percentage vote requirement be based on all outstanding shares entitled to vote and not on votes actually cast.



- O. Enacting redemption provisions where if any person owns a certain percentage of stock pursuant to a hostile tender offer, which is opposed by the management and/or Board of Directors, the other shareholders have the right to have their shares redeemed by the company at a specified price.
  - P. Requiring the Board and/or senior management to consider social, economic and "other factors" when evaluating a bid for the company, rather than basing its decision solely on the price being offered.
  - Q. Granting a director who is the Chairman or Chief Executive Officer a second or tie-breaking vote.
  - R. Reincorporating in other states solely for the purpose of seeking protection against tender offers and takeovers.
  - S. Issuance of new common and preferred shares and placing the issues in so called "friendly" hands, sympathetic to management.
  - T. Assuming large amounts of debt which will impair the capital position of the corporation, in order to repurchase the corporation's stock and avoid a tender offer.
- 2. Each proposal will be evaluated on its merits, but if it is determined that the sole aim of the proposal is to entrench management, and wrest authority and control from shareholders, a vote is to be cast against such proposals. However, this guideline is no substitute for the judgement of the responsible party.
  - 3. STRS also opposes so-called "Omnibus Resolutions, where management offers one item which is beneficial to shareholders, such as anti-greenmail, and attaches a "rider" or other items such as the ones described above, which are not in the best interests of shareholders. In this situation, a vote will be cast against the entire proposal. A letter (where appropriate) to management may be written by the designated party indicating displeasure with this "lumping" and requesting that the issues be separated.
  - 4. Generally, votes are to be cast against proposals which adopt or give the Board of Directors discretionary power to adopt measures designed to deter takeover attempts or other attempts to obtain control of the corporation by making such attempts extremely financially unattractive or impossible, unless such action has received the prior approval of the shareholders of that company. However, such actions will be reviewed on a case-by-case basis, and legal requirements and circumstances will dictate the Systems' vote on this matter.
  - 5. Reincorporation proposals will be examined on a case-by-case basis.

#### **G. CORPORATE FINANCING PROPOSALS**

- 1. Authorization of increased shares shall generally be limited to that amount which may be necessary for financing within the next twelve months unless the corporation sets forth other compelling reasons. It is deemed advisable to exercise some control over authorized stock and issuance thereof to allow shareholders input on acquisitions which could change the

fundamental characteristics of the company held. Support will generally be given for authorization of up to 15% in excess of the current outstanding stock. However, such actions will be reviewed on a case-by-case basis, and legal requirements and circumstances will influence the Systems' vote on this matter.

2. In general, all shareholder proposals on financial matters are to be given due consideration by STRS and/or its advisers. It is incumbent on the companies to respond adequately to these proposals. An inadequate or casual response may affect the responsible party's deliberations and weigh in favor of voting for the shareholder proposal.
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(1) Notwithstanding any other provision of the law, every state agency owning common stock shall, when returning proxies to a corporation, vote each proxy that is returned to the corporation. Nothing in this section shall prohibit a state agency owning common stock from abstaining on a corporate or shareholder proposal and notifying the corporation in writing of the state agency's desire to abstain on a corporate or shareholder proposal.

As used in this section "state agency" includes the state, the University of California, and any office, department, bureau, board, commission, agency, or pension or retirement system thereof.

Approved by Board: June 11, 1982

Amended by Investment Committee: June 7, 1985

Amended by Investment Committee: July 19, 1985

Amended by Subcommittee on Financial Proxies: August 5, 1988

Amended by Investment Committee: October 7, 1988

Ratified by Teachers' Retirement Board: October 22, 1988

Amended by Subcommittee on Corporate Governance: March 11, 1992

Approved by Investment Committee: April 1, 1992

Ratified by Teachers' Retirement Board: April 2, 1992

Amended by Subcommittee on Corporate Governance: October 6, 1995

Approved by Investment Committee: October 6, 1995

Ratified by Teachers' Retirement Board: October 6, 1995

Amended by Investment Committee: November 5, 1997

Approved by Investment Committee: November 6, 1997

Ratified by Teachers' Retirement Board: November 6, 1997

**Corporate Governance  
A Brief and Selective Chronology**

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<b>1925</b>	Nonvoting common stock first issued in significant amounts by large corporations
<b>1932</b>	Berle and Means' <u>The Modern Corporation and Private Property</u> published  Lewis Gilbert attends Annual Meeting of Consolidated Gas Company
<b>1934</b>	Securities Exchange Act becomes law and the Securities and Exchange Commission (SEC) is created William O. Douglas's "Directors Who Do Not Direct" published in <u>Harvard Law Review</u>
<b>1935</b>	Georgeson & Co. founded
<b>1939</b>	The Conference Board's "Prevailing Practices Regarding Corporate Director" published
<b>1940</b>	SEC recommends that companies established audit committees
<b>1942</b>	SEC adopts first shareholder proposal rule
<b>1946</b>	American Society of Corporate Secretaries founded Wilma Soss founds the Federation of Women Shareholders
<b>1947</b>	SEC v. Transamerica decided, including a Gilbert shareholder proposal in a corporate proxy statement
<b>1956</b>	Lewis Gilbert's Dividends and Democracy published
<b>1964</b>	Jl Case v. Borak decided, creating a private right of action under the proxy rules
<b>1966</b>	Exxon adds its first outside directors
<b>1968</b>	Williams Act amendments to Securities Exchange Act enacted
<b>1970</b>	Penn Central files for bankruptcy
<b>1971</b>	Myles Mace's <u>Directors: Myth Reality</u> published Interfaith Center on Corporate Responsibility founded The first church-sponsored proxy resolution is introduced

<b>1972</b>	General Motors establishes a nominating committee for its board Investor Responsibility Research Center is founded
<b>1974</b>	Inco acquires Electric Storage Battery in the first hostile takeover ERISA enacted The SEC requires proxy statement disclosure of whether a company has an independent audit committed
<b>1976</b>	“Directors & Boards” magazine first published First “unlawful payments” disclosure
<b>1977</b>	Foreign Corrupt Practices Act passed Sullivan Principles announced National Association of Corporate Directors (NACD) founded
<b>1978</b>	NYSE adopts its rule requiring independent audit committees Business Roundtable’s (BRT) “The Role and Composition of the Board of Directors” published The American Bar Association’s (ABA) “The Corporate Director’s Guidebook” published
<b>1979</b>	Reliance Electric adopts first “golden parachute” Kohlberg, Kravis, Roberts & Co. completes its first leveraged buy-out (LBO) of a public company
<b>1982</b>	Martin Lipton invents the “poison pill” The American Law Institute (ALI) prepares the first draft of its “Project on Corporate Governance”
<b>1984</b>	The Bass brothers “green-mail” Texaco
<b>1985</b>	The Council of Institutional Investors (CII) is founded <u>Smith v. Van Gorkom</u> decided by the Delaware Supreme Court, raising standards for directors Robert Monks founds Institutional Shareholder Services The Delaware Supreme Court decides Moran v. Household International (upholding the poison pill), as well as Unocal and Revlon, setting out standard for directors in takeovers
<b>1986</b>	T. Boone Pickens founds United Shareholders Association
<b>1987</b>	CalPERS sponsors its first governance proposal
<b>1988</b>	KKR Completes LBO of RJR Nabisco

## Corporate Governance-Chronology

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- 1989** Jay Lorsch and Elizabeth MacIver's Pawns or Potentates published  
The Valdez Principles created
- 1990** The Delaware Supreme Court decides *Paramount v. Time*  
Pennsylvania passes its antitakeover law  
BRT's "Corporate Governance and American Competitiveness" published
- 1991** Bud Crystal's "In Search of Excess" published  
The Working Group on Corporate Governance's "A New Company for Owners and Directors" published in Harvard Business Review
- 1992** The SEC eases its shareholder communication rules  
California voters approve Proposition 162  
GM fires Robert Stempel
- 1993** CEOs John Akers (IBM), James Robinson (American Express), Paul Lego (Westinghouse), Kay Whitmore (Kodak), Anthony D'Amato (Borden), Ken Olsen (Digital Equipment) all fired  
TIAA-CREF "Policy Statement on Corporate Governance" published  
ALI adopts "Principles of Corporate Governance"  
Joe Grundfest's "Just Vote No" published in Stanford Law Review
- 1994** GM "Guidelines" on governance published  
Department of Labor issues further guidance for fiduciaries relating to proxy voting and monitoring  
NACD "Blue Ribbon Commission" report on "Performance Evaluation of CEOs, Board and Directors" published  
The Delaware Supreme Court decides *Paramount v. QVC*
- 1995** Private Securities Litigation Reform Act passed  
NACD "Blue Ribbon Commissions" report on "Directors Compensation" published  
CEO Joseph Antonini (Kmart fired)
- 1996** The Teamsters first identify "American Least Valuable Directors"  
AT&T CEO Robert Allen is fired  
NACD "Blue Ribbon Commissions," report on Directors published  
ABA's Fundamentals of Corporate Governance published
- 1997** BRT "Statement on Corporate Governance" published  
CII adopts policies, practices and principles relating to corporate governance
- 1998** CalPERS adopts principles of corporate governance

## GLOSSARY

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**Annual Report** - Yearly (fiscal or calendar) record of a company's financial condition that must be distributed to shareholders under SECURITIES AND EXCHANGE COMMISSION REGULATIONS. Report includes operations as well as balance sheet and income statement.

**Auditors** - Professional examiners of companies' accounting documents, supporting data for the purpose of giving opinion as to documents/data fairness, consistency conformity with GENERALL ACCEPTED ACCOUNTING PRINCIPALS.

**Authorized Shares** - Maximum number of shares of any class a company may legally create under the terms of its ARTICLES OF INCORPORATION. Normally, increases or decreases must be approved by a vote of the STOCKHOLDERS.

**Balance Sheet** - Financial report showing the financial condition of a company on a given date; a listing of all assets and liabilities.

**Bankruptcy** - Insolvent state of a corporation either due to no-assets, financial reasons or litigation reasons. Equity and Creditor Committees are usually part of the settlement of obligations.

**Board of Directors** - Group of people, usually elected annually by shareholders to represent shareholders' interests. Board's powers are usually defined in the company's charter. Board has oversight responsibility, as well as power to appoint senior management, name members of executive, review and financial committees, appoint lead director, evaluate CEO, evaluate Board performance, develop succession plan, issue additional shares and declare dividends. Inside directors refer to company's executives who are also directors; Affiliated directors refer to directors who have other relationship(s) to company other than directorship; Outside directors are directors whose sole relationship to the company is the directorship.

**Chairman of the Board** - Highest ranking officer of the corporation.

**Chewable Poison Pill** - A poison pill that sets conditions that will allow certain kinds of unsolicited bids to proceed without triggering the pill. One version would nullify a pill if there is a fully-financed, all-cash offer for all outstanding shares at a premium to the current shares price.

**Chief Executive Officer** - Principal executive of the corporation.

**Class** - Securities which have similar features; usually itemized on a company's balance sheet.

## **Glossary**

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**Class Action** - Lawsuits filed by a pool of investors who are all members of the same class, usually defined by the type of shares held, the dates bought, sold or held and the transpiring of some even.

**Common Stock** - Representative ownership in a public corporation.

**Corporation** - Legal entity, either chartered federally or by states: Characteristics limited liability - owners can only lose what they invest; easy passing of ownership through the sale of stock; continuity of existence; ability to raise capital by expanding ownership, shareholders' ability to profit from the growth of the business.

**Creditors Committees** - Group representing creditors that have claims on a company in bankruptcy.

**Cumulative Voting** - Allows shareholders to cast all their votes for one director candidate. Improves minority shareholders chances of naming representatives to the Board of Directors.

**Dead Hand Provision Poison Pill** - Provision which states that only on the directors who were on the board when the pill was adopted or their designated replacements can redeem a pill prior to expiration.

**Dilution** - Effect on earnings per share and book value if all securities, warrants and stock options were exercised.

**Dual Class Capitalization** - Separation of equity features based on length of ownership, acquisition method or voting rights. Typically used as a means of control by minority investors.

**Employee Retirement Income Security Acts (ERISA)** - Federal law (1974) governing the operation of most private and benefit plans; established guidelines for the management of pension funds.

**Employee Stock Ownership Plan - ESOP** - Program encouraging lower level employees to purchase stock in their company.

**Equity Committees** - Group representing shareholders of a company in bankruptcy.

**Golden Parachute** - Compensation contracts given to top executives in the event the company is merged into or acquired by another firm.

**Greenmail** - Payment by a takeover target (company) to a potential acquirer, usually a premium payment, not offered to all shareholders.

**Indexing** - Weighting one's portfolios to match a broad based index such as S&P or Russell, in order to match it's performance.

## **Glossary**

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**Institutional Investor** - Organizations that invest in and trade large volumes of securities.

**Majority Shareholder** - Shareholder(s) who control more than half of the outstanding shares of a corporation.

**Market Value** - Market price - where willing buyers and sellers trade.

**Merger** - Combination of two or more companies, either through a pooling of interests or purchase accounting rules.

**New York Stock Exchange** - Largest stock exchange in U.S.

**Phantom Stock Plan** - Incentive compensation scheme where an executive receives a bonus based on the market appreciation of company's stock over specified period; usually proportionate to executive's salary; The executive pays nothing for this option and has nothing to lose - Stock Appreciation Rights, Performance Stock, Restricted Stock.

**Poison Pill** - Also called Shareholder Rights Plans; issuance of a new series of preferred stock designed to raise the cost of an acquisition and deter takeover bids, usually triggered by a certain percentage ownership.

**Proxy** - Generally defined as the authority or power to act for another; also refers to a document giving such authorization. In this manual, proxy means: the authority to exercise the voting rights to which the holder is entitled as a shareholder.

**Proxy fight** - Outsider acquires technique for gaining control of reluctant targets board of directors.

**Proxy Statement** - Information which the SEC requires shareholders to receive before they vote on company matters.

**Record Date** - Date by when shareholder must own stock in order to be entitled to vote or get a dividend.

**Reorganization** - Financial restructuring of a company in bankruptcy. Shareholders frequently vote on reorganization plans.

**Resolution Shareholder** - Formal expression of a desire or intent presented to corporations Board of Directors by it's shareholders usually non-binding.

**Share Repurchase Plan** - Program where a corporation buys back it's own shares in the open market.

**Staggered Board of Directors** - Where directors are elected in portions each year instead of all at the same time. Also known as classified board.



## **Glossary**

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**Statutory Voting** - Also known as one-share, one vote rule that governs procedure in most corporations; assures that majority will rule.

**Stock Purchase Plans** - Organized program for employees of a company to buy shares of stock (company) without commissions.

**Sunset Poison Pill** - Provision which allows Poison Pill to expire after specified period of time.

**Takeover** - A change in the controlling interest of a corporation, usually hostile.

**Tender Offer** - Offer to buy shares of a corporation, usually at a premium; usually unsolicited.

**Treasury Stock** - Stock reacquired by the issuing corporation, issued but not outstanding, often used to provide for the exercise of stock options.